COUNCILMEMBER CARL DEMAIO
FIFTH DISTRICT
CITY OF SAN DIEGO

MEMORANDUM

DATE: December 4, 2009

TO: Jan Goldsmith, City Attorney

CC: Honorable Mayor and City Councilmembers

FROM: Councilmember Carl DeMaio Carl DeMaio

RE: Legal Review of Possible Pension Reform Ideas

Following up from our meeting on November 3, 2009 – and as an expansion of the memorandum Councilmember Frye and I issued on October 12, 2009 – I wanted to outline a number of pension reforms my office is evaluating and seek your office's review of and input on potential legal hurdles to each.

Some argue that pension reform should be taken completely off the table – because pension benefits are "vested." Following that logic would mean taxpayers would have to brace themselves for further service cuts and tax increases – all in the name of servicing debt for unsustainable pension benefits.

I am committed to doing everything possible to avoid that undesirable outcome. I'd like to work with your office to research and pursue every possible legal remedy to addressing the city's unsustainable cost for pension benefits. For the past several months my office has compiled reforms that fall into the following categories:

a) reducing the pension debt through benefits reform,
b) reducing the pension debt through reforms that achieve actuarial savings (managed competition, salary freezes, reductions-in-force, etc.)
c) achieving savings in other parts of employee compensation to pay down accrued pension liabilities, or
d) a combination of all of the above.

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I am not suggesting that the city attempt to abrogate "vested" pension benefits – but I am suggesting that we expand the kinds of vehicles we can use for achieving reform. As California courts have noted, "[i]t is well established that public employees have no vested rights to particular levels of compensation and salaries may be modified or reduced by the proper statutory authority" (*Tirapelle v. Davis*, 26 Cal. Rptr. 666, 678 (Cal. Ct. App. 1993)).

This principle was recently validated by the City's prevailing argument in the United States Court of Appeals for the Ninth Circuit opinion in *San Diego Police Officers v SDCERS* regarding pending reforms to the Deferred Retirement Option Plan (DROP).

As such, many of the reforms my office is considering approach pension reform from an "employee compensation" perspective – making adjustments in what employees actually pay for retirement and attempting to put financial incentives on the table to encourage employees to "opt-out" of higher benefit tiers into lower benefit tiers to achieve improvements in their overall take-home pay.

Orange County Pension Reform

Orange County's model has some interesting features to its pension reform approach that I believe warrant close study.

Like San Diego, Orange County has created a two-tier benefit system of "old," more expensive benefits and new, more "sustainable" benefits – each requiring different levels of employer and employee contributions. There are several differences between the San Diego and Orange County pension scenarios – including different contribution rates for employees.

Unlike San Diego, Orange is attempting to provide employees with an "opt-out" vehicle to move them from the old tier to the sustainable tier. In this case the reform respects the vested nature of benefits already accrued, but reduces benefits on a go-forward basis. This vehicle is designed to reduce pension costs for the County – and county employees.

The model effectively gets around "vesting" problems. However, it may present tax compliance challenges (See attached IRS Letter – Attachment A.)

Questions for the City Attorney:

- Question 1: Do you concur with Orange County's determination that – from a vesting standpoint – pension benefits for existing employees can be reformed using the voluntary opt-out model?

- Question 2: Some argue that an exact dollar-for-dollar consideration be given if a vested pension benefit is reduced by the employer. However, if the reduction is **voluntarily** agreed to by an employee through individual contract by opting into a new plan, can the consideration be less than dollar-for-dollar? (e.g. money now in the form of relatively higher take-home pay today due to lower contribution rates may be more desirable than more money later in the form of pension benefits in retirement.)

- Question 3: While the IRS determination does not make the Orange County vehicle illegal, it would likely impact the tax exempt nature of employee contributions – possibly making them taxable as part of their employment package. Would the tax status of employees' past contributions into the system be impacted? Would contributions on a go-forward basis be impacted? Besides lower after-tax take-home pay for city employees, what other tax impacts, if any, would be seen?

- Question 4: Given Orange County's interest in pursuing regulatory clarification in this matter, how can San Diego assist in this effort to create this option for our city? (e.g. San Diego working to help secure passage of federal legislation allowing for this reform if needed)

Shifting to a "Total Compensation" Package for Employee Classifications

Given that the city now has a two-tiered pension, it is possible for new hires after July 1, 2009 to be doing the same work as employees in the old pension system and receiving different compensation packages. Both employees receive the same base salary, but one employee receives more compensation from the city by virtue of having more expensive pension benefits.

As noted above, courts have consistently ruled that salary is not a vested benefit. The City Charter also has language requiring substantially equal compensation be provided within job classifications.

The city could consider a "Total Compensation" Model for the Annual Salary Ordinance and related labor contracts. Under this model, the city would create a "total compensation allowance" for each job classification that sets a flat cost to the taxpayer for salary and all benefits – irrespective of what pension tier an employee is in.

The city would begin by paying for the employer contribution for pension, and then any remaining compensation allowance would apply to other fringe benefits and/or salary.[1] Employees in the old system would receive less take home pay and have less to spend on other fringe benefits – employees in the new system would have more take-home pay and other fringe benefits, but less generous retirement allowances from the pension system.

Under this model the city would see significant savings in salaries and benefits – savings that could be used to help offset our pension payment contributions – with the net effect of reducing service impacts from the pension liability.

Combined with a possible "opt-out" plan for employees similar to the one Orange County envisions, this pension reform could be quite powerful in providing management with what would emulate a "buy out" program to reduce the city's pension debt and increase annual operating capacity.

Question for the City Attorney:

- Question 5. Aside from the obvious need to meet and confer, what legal issues might be raised by this concept?

Reform of SPSP Pensions

On January 20, 2008 my office first proposed to eliminate the Supplemental Pension Savings Program (SPSP). At the time, many claimed that my proposal impacted "vested" benefits and could not be implemented. As you know, this idea was eventually negotiated and adopted in one of the city's labor contracts – saving taxpayers millions annually.

Unfortunately, while this reform has been implemented for employees in the Municipal Employees Association, the SPSP plan still exists for other employees represented by Local 127 and in the unclassified service. The city's cost for SPSP payments in the FY 2010 budget totals $23.6 million – with $13.5 million coming from the General Fund.

Reaching a mutual agreement with the MEA greatly aided the elimination of SPSP payments for two years with that bargaining unit. Some argue that the City retains the legal option to "suspend" this program year-to-year – with or without the consent of the bargaining unit (provided that the City faithfully negotiates and follows its impasse procedure in labor negotiations.)

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[1] The city would pay the employee and employer pension contribution first – in a manner that satisfies any vested rights to employee and employer contribution rates.

Question for the City Attorney:

- Question 6. Using the City's experience with MEA as a model, what legal options exist to impose elimination of this program for the FY 2011 budget for Local 127 and unclassified employees?

Eliminate "Employee Offsets" – Payments by City for Employee Contributions

The City of San Diego over the years has "picked up" a share of the employee's pension contribution – in addition to paying the employer contribution rate. These costly accommodations are known as "Employee Offsets."

While the Mayor and City Council made progress in eliminating offsets for several unions this year, thousands of city employees still do not pay their full employee contribution and the city is making up the difference. Eliminating this program entirely by FY 2012 would save approximately $8.7 million citywide ($5.2 million in the General Fund), using FY 2010 budgeted expenditures as a benchmark.

Courts have held that employee contribution **rates** are vested. However, courts have held that "offsets" are not vested as they are deemed part of compensation.[2]

Question for the City Attorney:

- Question 7. Assuming the city faithfully negotiates, are there any legal impediments to implementing this pension reform?

Reform of Employee Contribution Rates

The City of San Diego granted a number of retroactive pension benefits that created a sizeable portion of the pension debt. The City Charter also currently makes the city responsible for paying for liabilities for past service (retroactive benefits). On a go-forward basis, both of these policies should be reformed to prevent further creation of unfunded liabilities. Changing the Charter in this regard may or may not allow the city to begin charging city employees for past service liabilities.

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[2] The City of San Diego actually helped create case law in this area. *Wisley v. City of San Diego*, 10 Cal. Rptr. 765 (Cal. Ct. App. 1961), and *Allen v. City of Long Beach*, 287 P.2d 765 (Cal. 1955) found a vested right to the level of an employee's contribution amount. However, that vested right only pertained to total amount assigned to the employee, not the amount actually paid by the employee.

The City Charter also states that "The retirement system herein provided for shall be conducted on the contributory plan, the City contributing jointly with the employees affected there under. Employees shall contribute according to the actuarial tables adopted by the Board of Administration for normal retirement allowances…." (Emphasis added)

Questions for the City Attorney:

- Question 8. Are there pension benefits that have not been administered based on the "contributory plan?" If a benefit were found to have not had employee contributions, what remedies would exist to cure this deficiency?
- Question 9. Assuming the City Charter is changed to eliminate the language obligating the city to pay the entire cost of accrued liabilities for past service, could the city have employees on a go-forward basis pay the effective "equal share" for past service liabilities?
- Question 10. Has the City reviewed how SDCERS calculates the cost of "normal retirement allowances" to ensure that all appropriate pension benefits are included in the calculation? From a legal perspective, if a benefit were excluded from SDCERS calculation, could the city a) require an employee to contribute for it on a go-forward basis?

Framework for Pension Reform: Amending Charter Sec 143.1

Charter Section 143.1 grants city employees a de-facto veto on many changes the Mayor and City Council may want to make to the pension system. The Charter states "No ordinance amending the retirement system which affects the benefits of any employee under such retirement system shall be adopted without the approval of a majority vote of the members of said system."

Presently there are a number of benefit reforms already approved by the Mayor and City Council that are being delayed partially due to this provision – including changes in the DROP program for "Unclassified" employees and POA employees. Every day of delay potentially costs taxpayers – and contributes to the pension debt.[3]

More importantly, a number of the reforms outlined in the memorandum would be subject to Section 143.1 – and would surely be blocked by employees even if the Mayor and City Council voted to approve them.

[3] The City Attorney's Office has argued that the DROP program was never implemented with a proper vote under Section 143.1. SDCERS has informed the City that it will not discontinue DROP for certain employees without a vote under Section 143.1

Question for the City Attorney:

- Question 11. Does Section 143.1 present a limitation to the Mayor and City Council's ability to implement current and prospective reforms in the pension system? Is this Charter provision common in cities and counties, or relatively unique to San Diego?
- Question 12. Your office has opined that certain pension benefits (such as DROP) were not properly voted on in accordance with the strict terms of Section 143.1. What other benefits besides DROP failed to achieve a proper Section 143.1 vote? What is our legal strategy for adjudicating our claims under this argument?

Orange County Case on "Earned Compensation" Clause of State Constitution

Orange County currently has a case on appeal challenging retroactive pension benefits using two arguments – creation of debt in excess of legal limits and violating "extra compensation" clause of the California Constitution.

The California Constitution includes provisions prohibiting a government entity from granting "extra compensation" to "any public employee" for service that has already been rendered. Specifically mentioned on page 11 of the Second Amended Complaint (See Attachment B):

> *Article XI, Section 10(a) of the Constitution provides, in relevant part, that a "local government body may not grant extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part."*
>
> *Similarly, Article IV, Section 17 of the California Constitution makes clear that the state legislature has no power to nullify this constitutional limitation by authorizing extra compensation that would otherwise be prohibited: "The legislature has no power to grant, or to authorize a city, county, or other public body to grant, extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part..."*

The Orange County case is important for the City of San Diego to watch – as it may open up avenues for reforming benefits that are currently assumed to be vested.

Question for the City Attorney:

- Question 13. Should Orange County prevail on appeal with its case on the grounds that retroactive benefits violate the "extra compensation" provisions of the state Constitution, what would the impact be to the City of San Diego?

Our Obligation to Explore All Avenues of Reform

I recognize that some of the ideas outlined above may not be practical for implementation due to legal and financial obstacles. However, I believe we have an obligation to taxpayers to faithfully investigate and research all reform options – and I appreciate your office's commitment to do just that.

It is clear that case law surrounding public sector pensions continues to evolve. Your office has been a significant part of that evolution – most recently with your victory in the DROP case.

As my office continues to canvass for possible pension reforms, I will keep you informed. Should your office have any questions about the concepts outlined in this memorandum, please do not hesitate to contact us.

I look forward to receiving your responses and moving the process of reforming the city's liabilities forward.

Internal Revenue Service
United States Department of the Treasury

Internal Revenue Bulletin: 2006-35
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Rev. Rul. 2006-43

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Government pick-up plans; employer contributions; income tax; prospective application. This ruling describes the actions required for a state or its political subdivisions, etc., to "pick-up" or treat certain contributions as employer contributions to a plan qualified under section 401(a) of the Code. If certain criteria are met, this ruling will be applied prospectively. Rev. Ruls. 81-35, 81-36, and 87-10 amplified and modified.

ISSUES

What actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to "pick up" employee contributions to a plan qualified under § 401(a) of the Internal Revenue Code so that the contributions are treated as employer contributions pursuant to § 414(h)(2)?

FACTS

Employer M is a political subdivision of State N. Employer M participates in Plan A, a defined benefit pension plan qualified under § 401(a) and established by State N to provide retirement benefits to eligible employees of State N and any political subdivision of State N. Plan A requires each participating employee to make employee contributions to Plan A equal to a specified percentage of the participant's salary. These amounts, designated as employee contributions under § 414(h)(1), are deducted from the participant's salary. State N statutes governing Plan A permit any political subdivision to provide that the employee contributions will be paid by the employer in order to be picked up and treated as employer contributions under § 414(h)(2). On March 1, 2006, Employer M amends its governing laws to provide that the amounts designated as employee contributions under Plan A will be paid by Employer M for all of Employer M's employees in order to be treated as employer contributions under § 414(h)(2), as permitted under the statutes governing Plan A. The amendment is in writing, was adopted by persons authorized to amend Employer M's governing laws, and is effective for periods on or after April 1, 2006. Employer M, thereafter, treats the amounts as employer contributions, instead of as being employee contributions, for federal income tax purposes and does not include these amounts in the participating employees' gross income.

LAW AND ANALYSIS

Section 414(h)(1) provides that any amount contributed to a qualified plan is not treated as having been made by the employer if it is designated as an employee contribution.

Section 414(h)(2) provides a special rule for qualified plans established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing. Under this rule, contributions, although designated as employee contributions, are nevertheless treated as employer contributions if the contributions are picked up by the employing unit.

Section 401(k) provides the rules relating to cash or deferred elections. Section 1.401(k)-1(a)(1) of the Income Tax Regulations provides that a plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension or rural cooperative plan, does not satisfy the requirements of § 401(a) if the plan includes a cash or deferred arrangement. Thus, a qualified defined benefit plan is not permitted to include a cash or deferred arrangement.

Section 1.401(k)-1(a)(3) generally defines a cash or deferred election as any direct or indirect election (or modification of an earlier election) by an employee to have the employer (i) provide an amount that is not currently available to the employee in the form of cash or some other taxable benefit, or (ii) contribute an amount to a trust or provide an accrual for a plan deferring the receipt of compensation.

Rev. Rul. 77-462, 1977-2 C.B. 358, addresses the income tax treatment of contributions picked up by the employer within the meaning of § 414(h)(2). In Rev. Rul. 77-462, the employer school district agreed to "pick up" and pay the required contributions of the eligible employees under the plan. The revenue ruling holds that the contributions picked up by the school district are excluded from the gross income of employees until such time as they are distributed to the employees.

Rev. Rul. 81-35, 1981-1 C.B. 255, and Rev. Rul. 81-36, 1981-1 C.B. 255, address certain requirements for contributions to be picked up by an employer within the meaning of § 414(h)(2). These revenue rulings establish that the following criteria must be satisfied: (i) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (ii) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the plan.Rev. Rul. 81-35 and Rev. Rul. 81-36 apply even if the employer picks up the contributions through either a reduction in salary or an offset against future salary increases.

Rev. Rul. 87-10, 1987-1 C.B. 136, addresses when contributions designated as employee contributions (designated employee contributions) under § 414(h)(1) to a qualified plan established by a State government (including a political subdivision thereof, or any agency or instrumentality of the foregoing) are excludable from the gross income of the employee. The ruling concludes that, to satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, the governmental action necessary to effectuate the "pick-up" must be completed before the period to which such contributions relate. Thus, designated employee contributions to a qualified plan established by a State government are excluded from gross income as "pick-up" contributions that are treated as employer contributions only to the extent the contributions relate to compensation for services rendered after the date of the last governmental action necessary to effectuate the "pick-up."

Based on the foregoing, a contribution to a qualified plan established by a State government will not be treated as picked up by the employing unit under § 414(h)(2) unless the employing unit:

(1) Specifies that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (*e.g.*, minutes of a meeting, a resolution, or an ordinance).

(2) Does not permit a participating employee from and after the date of the "pick-up" to have a cash or deferred election right (within the meaning of § 1.401(k)-1(a)(3)) with respect to designated employee contributions. Thus, for example, participating employees must not be permitted to opt out of the "pick-up", or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Employer M has taken formal action which was memorialized in a contemporaneous writing that provides that it will "pick up" all prospective contributions for the Employer M employees who are required to contribute to Plan A. Further, employees are required to participate in Plan A, do not have the option of choosing to receive the contributed amounts directly, and may not make a cash or deferred election with respect to such amounts. Employer M has met the requirements to have the designated employee contributions under Plan A picked up and treated as employer contributions pursuant to § 414(h)(2). Thus, contributions made to Plan A are not includible in a participant's gross income until distributed under § 402.

This revenue ruling applies only for federal income tax purposes. See §§ 3121(a)(5)(A) and 3121(v)(1)(B) of the Federal Insurance Contributions Act (FICA) for the treatment of amounts treated as an employer contributions under § 414(h)(2).

HOLDING

Because an authorized person has taken formal action in writing prospectively to have the employing unit pay previously designated employee contributions to a § 401(a) qualified plan, appropriate actions have been taken for the contributions to be picked up by the employing unit and treated as employer contributions pursuant to § 414(h)(2).

TRANSITION RELIEF FOR PRE-EXISTING "PICK-UPS"

Under the authority of § 7805(b)(8), the Service will not treat any plan that on or before August 28, 2006, includes designated employee contributions that were intended to be picked up as employer contributions pursuant to § 414(h)(2) as failing to meet the requirements of such section prior to January 1, 2009, solely on account of the failure to satisfy the requirement that the "pick-up" be pursuant to a formal action, by a person duly authorized to take such action with respect to the employing unit, that is evidenced by contemporaneous writing, but only if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a "pick-up" (*e.g.*, provided information to employees relating to the establishment of the "pick-up") and has operated the plan accordingly; and (2) the employing unit takes formal action in writing prior to January 1, 2009, with respect to future contributions to meet the requirements set forth above in paragraph (1) of *Law and Analysis* in this revenue ruling.

The relief provided above for "pick-ups" implemented prior to August 28, 2006, applies only if the actions taken otherwise complied with Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10, and only if the employing unit has not reported the contributions as wages subject to federal income tax withholding from and after the date of implementation of the intended "pick-up".

In addition, under the authority of § 7805(b)(8), this revenue ruling does not modify or revoke any private letter ruling issued to any taxpayer prior to August 28, 2006. See § 601.201(l)(4).

EFFECT ON OTHER GUIDANCE

Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10 are amplified and modified.

DRAFTING INFORMATION

The principal drafter of this revenue ruling is Kathleen Herrmann of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:30 a.m. and 4:30 p.m. Eastern Time, Monday through Friday. Ms. Herrmann may be reached at (202) 283-9888 (not a toll-free number).

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COUNTY OF ORANGE

SUPERIOR COURT FOR THE STATE OF CALIFORNIA

COUNTY OF LOS ANGELES

COUNTY OF ORANGE, CALIFORNIA, a political subdivision of the State of California, Plaintiff, vs. ASSOCIATION OF ORANGE COUNTY DEPUTY SHERIFFS and BOARD OF RETIREMENT OF THE ORANGE COUNTY EMPLOYEES RETIREMENT SYSTEM, a local public entity, Defendants.	Case No. BC 389758 Assigned For All Purposes To: The Honorable Helen I. Bendix **SECOND AMENDED COMPLAINT FOR DECLARATORY, INJUNCTIVE, AND OTHER RELIEF** Complaint Filed: February 1, 2008 First Amended Complaint Filed: July 23, 2008 Trial Date: None Set
ASSOCIATION OF ORANGE COUNTY DEPUTY SHERIFFS, Cross-Complainant	

49. California cases do not recognize any exception to the Article XVI, Section 18 debt limit for cases where a government has taken unconstitutional action and then made a contract about the action.

50. A government cannot convert an unconstitutional act into a lawful act by embodying its unconstitutional action in a contract. Nor can a government be estopped from correcting actions that it had no authority to undertake in the first instance.

51. The County's execution of one or more contracts with employees purporting to obligate the County to fund the provision of benefits as a result of the implementation of the retroactive portion of the Resolution No. 01-410 pension benefit enhancement adds nothing to the analysis of the constitutionality of the enhancement.

52. Individuals who stand to receive benefits as a result of the continued implementation of the retroactive portion of the Resolution No. 01-410 pension benefit enhancement have no vested right to continue receiving any portion of benefits received in violation of the Constitution. There can be no vested right to a constitutional wrong.

California's Constitution Prohibits Granting Extra Compensation To Favored Public Employees

53. California's Constitution includes provisions prohibiting government from granting "extra compensation" to any "public employee" for service that already has been rendered.

54. Article XI, Section 10(a) of the Constitution provides, in relevant part, that a "local government body may not grant extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part."

55. Similarly, Article IV, Section 17 of the California Constitution makes clear that the state legislature has no power to nullify this constitutional limitation by authorizing extra compensation that would otherwise be prohibited: "The Legislature has no power to grant, or to authorize a city, county, or other public body to grant, extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part ...."